VZCZCXRO5054
PP RUEHAST RUEHCI RUEHDBU RUEHLH RUEHNEH RUEHPW
DE RUEHBI #0041/01 0341135
ZNR UUUUU ZZH
P 031135Z FEB 10
FM AMCONSUL MUMBAI
TO RUEHC/SECSTATE WASHDC PRIORITY 7714
INFO RUCNCLS/ALL SOUTH AND CENTRAL ASIA COLLECTIVE
RUEHCG/AMCONSUL CHENNAI PRIORITY 2202
RUEHCI/AMCONSUL KOLKATA PRIORITY 1989
RUEHNE/AMEMBASSY NEW DELHI PRIORITY 8924
RUEHBI/AMCONSUL MUMBAI PRIORITY 2955
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

UNCLAS SECTION 01 OF 03 MUMBAI 000041

SENSITIVE
SIPDIS

DESK PLEASE PASS TO USTR

E.O. 12958: N/A
TAGS: ECON EFIN EIND EINV IN
SUBJECT: RBI MOVES AHEAD OF THE CURVE TO SIGNAL INFLATION
EXPECTATIONS

MUMBAI 00000041 001.2 OF 003

¶1. (U) Summary: On January 29, the Reserve Bank of India (RBI), India's central bank, raised the cash reserve ratio (CRR), its first direct step towards monetary tightening in an effort to fight rising inflation, which the RBI now expects to be 8.5 percent for the fiscal year. The belt tightening would withdraw $7.8 billion of the current $15.17 billion liquidity from the banking system. However, neither the central bank nor bankers expected this hike to have any immediate impact on lending rates or on growth, as the RBI dramatically revised its projection for 2009-10 for GDP growth to 7.5 percent from its previous 6.0 percent. Acknowledging the risk of a large fiscal deficit, the central bank also urged the Indian government to implement fiscal discipline measures. RBI noted that the reversal of monetary actions would not be effective unless there is a roll back in government borrowing. End Summary

RBI Takes First Monetary Step Towards Tightening
------------------------------

¶2. (U) On January 29, the Reserve Bank of India (RBI), India's central bank, took its first direct step to tighten monetary policy in its third quarter monetary review. The RBI aggressively raised the CRR (the percentage of deposits which must be kept with RBI) by a more than expected 75 basis points (bps) to 5.75 percent. The market consensus view expected a 50 bps hike. The CRR hike will be implemented in two stages -- a 50 bps increase effective February 13 and the remaining 25 bps beginning February 27. This move cumulatively will suck out $7.8 billion of the current $15.17 billion liquidity from the banking system. Other policy rates -- the repo (the interest rate at which RBI lends to banks) and the reverse repo rate (the interest rate RBI pays to banks for funds deposited with it) -- were kept unchanged, in line with market expectations. In its previous policy review of October 2009, the RBI had announced terminating some sector-specific facilities and restoring the statutory liquidity ratio (the proportion of bank liabilities held in government securities) to the pre-crisis level.

¶3. (U) The RBI Governor, Dr. D Subbarao, noted that the CRR hike would definitely raise the cost of funds for banks, but that banks had assured the RBI that lending rates would not go

up immediately and generally supported the move. O.P. Bhatt, Chairman of the government-owned State Bank of India (India's largest bank) told the media that the CRR hike will not have a significant impact on interest rates. However, Bhatt added, corporate borrowing rates could rise. Aditya Puri, the Managing Director of HDFC Bank, said that even if interest rates increase after six months, it would be in the range of 0.5-0.75 percent. This increase, Puri thought, would not impede credit growth.

RBI Raises Growth and Inflation Forecast

----------------------------------------

¶4. (U) The RBI raised both its growth and inflation forecast for 2009-10 in its policy review. In the October 2009 monetary policy review, RBI had projected 2009-10 GDP growth at 6.0 percent, with an upward bias. "Assuming a near zero growth in agricultural production and continued recovery in industrial production and services activity, the projection for GDP for 2009-10 is now raised to 7.5 percent", the RBI determined. On revising growth targets dramatically, Governor Subbarao listed the positive prospects of a better-than-expected winter crop, a stronger industrial and export recovery, and a revival in consumption and investment. On the inflation front, citing rising commodity prices globally and the domestic demand-supply balance, the RBI raised its inflation projections as measured by the Wholesale Price Index (WPI) for March 2010 to 8.5 percent, up from 6.5 percent.

¶5. (U) In the third quarter review of Macroeconomic and



Monetary Developments, a report which serves as a background to the review of monetary policy, the RBI noted the difficulties in using monetary policy measures to address rising food price inflation and supporting the return to high growth. In December 2009, WPI-measured inflation was at 7.3 percent; excluding food articles, WPI-measured inflation was only 2.1 percent, accentuating the concentrated nature of inflation. But the RBI also warned of the risk of food price inflation transmitting to other non-food items through expectations-driven wage and price revisions, which may translate into a generalized inflation. The RBI acknowledged, however, that the monetary policy tools in its purview are limited in their impact, and can only address liquidity factors causing inflation, and not the rise in food prices, per se.

RBI Calls for Fiscal Prudence

----------------------------

¶6. (U) In its monetary policy review and the subsequent press statement, the RBI urged the government to implement fiscal discipline measures. The RBI acknowledged that "by far a bigger risk to both short-term economic management and to medium-term economic prospects emanates from the large fiscal deficit." In 2008-09 and 2009-10, government borrowing increased significantly, reached a record USD 92.53 billion this fiscal year. In the meeting with the RBI subsequent to the policy, banks noted that if the government borrowings continue to remain large, it would put additional pressure on resources and interest rates. This borrowing was managed by the RBI through a host of liquidity measures, including buying back bonds and unwinding short-term debt bonds. However, the RBI warned that such liquidity infusion options would not be available to the same extent next year. Moreover, with expectations of strong

growth in private credit demand, RBI said there is a threat of public borrowing crowding out companies in needs of funds. Therefore, the RBI pointed out a need for co-ordination between the central and the GOI in their fiscal and monetary exit plans.

RBI Revises Bank Credit Growth

------------------------------

¶7. (U) The RBI in its policy report reduced the non-food credit growth from 18 percent to a realistic 16 percent. Chanda Kochhar, MD & CEO, ICICI Bank said that the RBI had undertaken a fair assessment of credit growth. The banking sector has achieved about a 14 percent growth in the first nine months and therefore the initially RBI-indicative 18 percent growth was unlikely to be achieved, she added. Nevertheless, she did foresee credit growth picking up considerably in the next fiscal year. Bankers present at the release of the policy report reiterated that credit growth prospects remained favorable going forward. They emphasized the need to expand their capital base for sustained future lending. Bankers were also concerned about the growing bank exposure to the infrastructure sector and the need to address the issue of asset-liability mismatch. They requested for an appropriate policy intervention both from the government and RBI.

RBI Conducts First Ever Teleconference

---------------------------

¶8. (U) The RBI Governor and Deputy Governors for the first time held a post-policy conference call with researchers and analysts to improve dissemination of its viewpoint and also to receive direct feedback. Apart from reiterating what had been said in the pre-policy macroeconomic review and the main monetary policy, the RBI board calmly responded to market participants' queries. The RBI accepted that bank lending to infrastructure



is indeed high, but suggested various mechanisms -- including bank syndication and corporate bonds - that could be used to meet infrastructure funding needs without breaching the single or group borrower exposure norms. On the issue of capital inflows, Governor Subbarao said that if the inflows were far in excess of the current account deficit, only then would measures such as lowering non-resident Indian deposit rates or increasing restrictions on external commercial borrowing and foreign institutional investor exposure to government and corporate debt be considered. Regarding Non-Performing Loans (NPL), the RBI claimed that the loan restructuring scheme had averted a marked increase in NPLs. However, they needed to wait for another quarter to get a concrete view on how much of the restructured loans would turn into NPLs. So far, the feedback from banks suggested that this would not become a serious problem, the RBI said.

¶9. (SBU) Comment: This monetary policy review represented a challenge to the RBI and its views on growth and inflation. The RBI recognized the need to begin draining excess liquidity in the system, but feared that too severe move - such as raising policy rates -- would dampen India's rapid return to high growth, now in full progress. The CRR hike was a relatively painless and expected move, in line with the logic of its monetary reviews. The move confirms that the RBI has shifted its direction, and more tightening could be ahead if concerns

over inflation begin to outweigh the benefits of growth.  End
Comment.
FOLMSBEE